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Financial Markets

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research &
Planning Division

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Rate spreads in financial markets are like tea leaves waiting to be read. Spreads are affected by a number of special factors. For example, risk perceptions might change and affect the spreads of private paper with respect to U.S. government issues. However, interest rate expectations are the critical determinant of yield differences when comparing debt instruments of the same borrower for different maturities. Thus we can try to isolate certain factors and look for the effects of market expectations on various interest rate spreads.

First of all, recent rate movements have been extremely limited, implying a rather steady configuration of interest rate spreads. In particular, the Fed funds rate has been exceptionally steady at about 9.5%, while three-month domestic certificates of deposit (CDs) have hovered around 9.4%. The relevance of this rate spread is best seen on a cost of funds basis. Banks can short-fund themselves by consistently borrowing Fed funds overnight or by engaging in term funding by issuing CDs--usually in maturities of one, two, three, or six months. And, since both Fed funds and CDs are sold by banks, interest rate expectations are at the core of the difference in these rates. To banks, the cost of CD funds is the cost of the usable funds the CDs generate. With a reserve requirement on CDs of 3%, this means that 3% of the funds raised through CDs are not usable. Thus with interest rates at 10% the cost of CD money is raised to 10.3%; the cost of FDIC insurance adds another 8 basis points, to approximately 10.38%. However, the comparison of the cost of CD money to that of Fed funds also depends on the funds rate expected to prevail throughout the life of the CD. This implies a comparison of the cost of CD funds to a compounded expected cost of Fed funds. (The compounding over three months adds about 10 basis points to the funds rate.) Thus with CDs trading to yield 9.4% and with Fed funds at 9.5%, the cost difference works out to be about 15 basis points in favor of Fed funds considering all these factors.

Even though CD rates are below the funds rate, Fed funds are a cheaper source of financing for banks--this is due mostly to the reserve requirements on CDs. However, this calculation also depends critically on the future level of the Fed funds rate. I have implicitly assumed that the funds rate will stay at 9.5% over the three-month life of the CD for my calculation. Making this same calculation for previous periods, and adjusting for changes in reserve requirements, reveals that the current spread is low. During periods of steady interest rates, and, therefore steady rate expectations, CDs usually cost 40-50 basis points more than Fed funds, not 15 as now. Banks are willing to pay more for three-month CDs because these instruments provide an opportunity to lock in a rate and reduce interest rate risk. Given these factors, the current 15 basis point cost advantage of Fed funds is low. This suggests the market is using a lower rate for Fed funds in its calculation, implying that the market expects Fed funds to drop somewhat over the next three months.

Although such calculations are crude, they provide a method for inspecting market rates and judging current market thinking. The CD market does not seem to think that Fed funds belong at 9.5%; a level of 9.3% or lower is more consistent with the recent trading ranges for CDs. But remember, this doesn't necessarily make the CD market right.

Robert A. Brusca

Irving Trust

Market Yields

	2/3/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	11.00%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	8.50
Federal Funds	9.44	9.25	8.38
Repurchase Agreements	9.40	9.05	8.38
U.S. Treasury Issues			
Bills			
3 months	9.25	9.24	8.50
6 months	9.52	9.50	8.84
1 year	9.75	9.79	9.09
Coupons			
2 years	10.53	10.61	9.80
4 years	11.09	11.10	10.27
7 years	11.51	11.49	10.84
10 years	11.62	11.59	10.99
Long Bond	11.72	11.69	11.10
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.25	9.25	8.45
3 months	9.35	9.35	8.70
6 months	9.45	9.45	9.00
1 year	9.85	9.90	9.40
Banker's Acceptances			
1 month	9.25	9.25	8.50
3 months	9.35	9.38	8.70
6 months	9.55	9.57	9.00
Eurodollar Deposits			
1 month	9.63	9.69	9.00
2 months	9.69	9.75	9.19
3 months	9.75	9.81	9.31
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.45	9.29	8.63
1 month	9.45	9.40	8.68
3 months	9.44	9.49	8.68
Bank Holding Companies			
1 month	8.94	8.94	8.17
Dealer Placed:			
3 months	9.60	9.52	8.73
New AA Corporate Utility Bond	12.80	12.80	12.60
Tax Exempt			
6 month Project Notes	5.00	5.20	4.50
1 year AAA Bond	5.40	5.40	5.00
5 year AAA Bond	6.85	6.80	6.25
20 year AAA Bond	8.95	8.90	8.80

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

Cable Address:
"IrvingBank" Telex: I.T.T. 420268 • R.C.A. 232241
W.U.I. 62832 • French 82629